Internal Revenue Service

memorandum

CC:TL-N-7042-86
Br1:LBJack

date: JUL 24 1986

to: Acting District Counsel, New Orleans
Attn: Scott Welch

from: Director, Tax Litigation Division

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subject: [redacted]
Proposed Statutory Notice - Taxable years [redacted] and [redacted]

This is in response to your memorandum of June 12, 1986, requesting technical advice in connection with the above-captioned case.

ISSUE

Whether, under Louisiana's community property laws, the taxpayer/wife is taxable on one half of her husband's earnings during the period between her petition for separation and the final judgment of separation. 0061.31-00.

CONCLUSION

Under Louisiana community property law, a judgment of separation or divorce is retroactively effective as of the date of the petition.

For federal income tax purposes, however, the state court's final decree will be given retroactive effect for the tax year in which the decree was rendered, but not for prior, closed tax years. Accordingly, even if the petition for separation had been filed in a prior tax year, the retroactivity of the final decree under state law will not operate to change the federal tax consequences of the prior year.

FACTS

In [redacted] petitioned the Louisiana state court for separation from her husband. A judgment of separation was entered by the court in [redacted] and a divorce was granted in [redacted]. Based on Rev. Rul. 74-393, 1974-2 C.B. 28, the examiner determined that the marital community was not dissolved until the date of the judgment of separation. Accordingly, the proposed notices of deficiency treat the income earned by the [redacted] from [redacted] through [redacted], as community income, one half of which is taxed to each spouse. 1/ Similarly, expenses and withholding credits during this period are allocated one half to each spouse. Alimony paid during this period from community funds is disallowed to the husband and not taxed to the wife.

You have been asked to review the proposed notices of deficiency, as to which the statute of limitations for assessment expires on [redacted]. You intend to advise the District Director to redetermine the proposed deficiencies by recognizing the dissolution of the marital community retroactively to the first day of the taxable year in which the judgment of separation was entered. We agree.

DISCUSSION

With respect to community income, as with respect to other income, federal income tax liability follows ownership. Blair v. Commissioner, 300 U.S. 5, 11-14 (1937). In the determination of ownership, however, state law controls. Burnet v. Harmel, 287 U.S. 103, 110 (1932). In this case, it is Lousiana law that determines the point at which the marital community is dissolved and the income is no longer owned by the spouses jointly.

While spouses are domiciled in Louisana, their residency gives rise to a "legal regime of community of acquets and gains," absent a valid matrimonial agreement to the contrary. La. Civ. Code Ann. arts. 2327, 2328 and 2334 (West 1985). With certain exceptions not here relevant, each spouse is the owner of a present undivided one half interest in all income earned during the existence of the community. Arts. 2336, 2337; Bender v. Pfaff, 282 U.S. 127 (1930).

1/ Relief under I.R.C. § 66, relating to the treatment of community income where spouses live apart, is not available in this case due to the wife's receipt of alimony during the years in question. Similarly, the wife is not entitled to relief as an innocent spouse under section 6013(c) because she and her husband did not file a joint return.

For many years, the wife's interest in the community property was viewed by the courts as:

> ...not a mere expectancy during the marriage; it is not transmitted to her by or in consequence of a dissolution of the community. The title for half of the community property is vested in the wife the moment it is acquired by the community or by the spouses jointly, even though it be acquired in the name of only one of them....

Phillips v. Phillips, 107 So. 584, 588 (La. 1926). See also United States v. Mitchell, 403 U.S. 190 (1971), relying on Phillips.

Phillips was overruled, however, by Creech v. Capitol Mack, Inc., 287 So. 2d 497 (La. 1974), and the wife's community property was given the following more restrictive description:

> We conclude that the wife's interest in the community is imperfect ownership without use, and consists of certain acquired rights including suit for separation of the community, acceptance or renouncing of the community, and a full accounting upon dissolution of the community.

287 So. 2d at 510. See Bagur v. Commissioner, 603 F.2d 491, 494 n.3 (5th Cir. 1979). Cf. O.M. 18290, Brent, Mary Ellen, I-5000 (Oct. 9, 1975).

The community of acquets and gains continues in existence until the death of one spouse or until a judgment of divorce or separation has been rendered. Art. 2356.

Under articles 155 and 159, judgments of separation or divorce are retroactive, such that the community is deemed to have been dissolved as of the date the petition for separation or divorce was initially filed. Patterson v. Patterson, 417 So. 2d 419 (La. App. 1982).

Thus, if a judgment of divorce or separation is eventually granted, the husband's earnings during the pendency of the divorce action are retroactively treated under Lousiana law as his separate property. Roberts v. Roberts, 325 So. 2d 674 (La. App. 1976). If the spouses are reconciled, the husband's interim earnings remain community property. Art. 155. The wife's earnings during separation are her separate property regardless of the outcome of the divorce action. Lewis v. Baxter, 428 So. 2d 1307 (La. App. 1983).

Article 155(b) contains an exception to the retroactive judgment rule, ostensibly to protect third party creditors. Specifically, the statute provides that the "retroactive effect shall be without prejudice...to rights validly acquired in the interim between commencement of the action and recordation of the judgment." See Aime v. Herbert, 254 So. 2d 299 (La. App. 1971)

It has been the Service's position that the retroactive feature of article 155 will not be given federal tax effect. Rev. Rul. 74-393, 1974-2 C.B. 28, holds that for federal tax purposes, the community exists until the final judgment of separation or divorce is granted. Thus, any income realized between the filing of the petition and the judgment of divorce or separation is treated as community income and taxed one half to each spouse.

The position embodied by the ruling was vindicated in Brent v. Commissioner, 630 F.2d 356 (5th Cir. 1980). There, the husband filed a petition for divorce in 1970 and the court entered a judgment of divorce in 1971. Pursuant to Rev. Rul. 74-393, the Service taxed one half of the husband's 1970 earnings (about $38,000) to the wife, even though she only received $4,800 of alimony from her husband during that period. The Tax Court held that since the 1971 divorce decree retroactively terminated the wife's state law rights to one half of her husband's earnings as of the date the divorce petition was filed in 1970, the wife could not be taxed on her husband's post-petition earnings.

The Fifth Circuit reversed, based on the annual accounting rule. The Court of Appeals would not let an event occurring after the close of the 1970 tax year (i.e., the 1971 judgment of divorce), change the federal tax treatment of income earned in the prior closed year. See, e.g., United States v. Anderson, 269 U.S. 422 (1926); Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931); United States v. Lewis, 340 U.S. 590 (1951).

In the present case, the petition for separation was filed in [redacted] and the judgment of separation was granted in [redacted]. We would agree that under Brent and Rev. Rul. 74-393, the instant taxpayer/wife would be taxable on one half of her husband's [redacted] earnings. At the close of the [redacted] tax year the marital community between [redacted] was still in existence, and in light of the annual accounting principle, the subsequent state court judgment could not change the tax treatment of the prior year.

It is [redacted]'s [redacted] and [redacted] tax years, however, which are presently at issue. As to [redacted], it is clear that [redacted] would be taxable on none of her husband's earnings during that year because the community was dissolved upon the entry of a judgment of separation in [redacted].

The tax treatment of the husband's [redacted] earnings is the sticky question. On its face, Rev. Rul. 74-393 would appear to resolve the issue by ignoring the retroactivity of the Louisiana statute and treating all income earned by the husband up until the date of the judgment as community income. We believe, however, that the two-part rationale of Rev. Rul. 74-393 as well as the underlying GCM's 2/ does not apply in the year the judgment is rendered.

The primary basis for the holding of Rev. Rul. 74-393 is the annual accounting rule. As mentioned above, this rule stands for the general proposition that an event occuring after the close of the tax year may not affect the federal tax treatment of the closed year. See, e.g., Burnet v. Sanford & Brooks Co., supra, 282 U.S. at 363-65 (income in later year could not be applied to offset losses in earlier years); United States v. Lewis, supra, 340 U.S. at 592 (loss in later year could not be applied to offset income in earlier year).

More specifically, it has been held in many different contexts that a retroactive state court judgment may not affect the federal tax treatment of a closed year or transaction. See, e.g., American Nurseryman Publishing Co. v. Commissioner, 75 T.C. 271, 275 (1980), aff'd by order, (7th Cir. Nov. 23, 1981); Harris v. Commissioner, 461 F.2d 554, 556 n.2 (5th Cir. 1972), aff'g T.C.M. 1971-172; Van Den Wymelenberg v. United States, 397 F.2d 443, 445 (7th Cir. 1968); Emerson Institute v. United States, 356 F.2d 824 (D.C. Cir. 1966), cert. denied, 385 U.S. 822 (1966); Piel v. Commissioner, 340 F.2d 887 (2d Cir. 1965), aff'g T.C.M. 1963-346; Sinopoulo v. Jones, 154 F.2d 648 (10th Cir. 1946); Estate of Hill v. Commissioner, 64 T.C. 867 (1975), aff'd by unpublished opinion, 568 F.2d 1365 (5th Cir. 1978); Davis v. Commissioner, 55 T.C. 416, 428 (1970); M.T. Straight

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2/ GCM 35082, [redacted], CC:I-4694 (Oct. 18, 1972) and GCM 35787, [redacted], I-4694 (April 19, 1974).

Trust v. Commissioner, 24 T.C. 69 (1955), aff'd, 245 F.2d 327 (8th Cir. 1957); Van Vlaanderen v. Commissioner, 10 T.C. 706 (1948), aff'd, 175 F.2d 389 (3d Cir. 1949); Daine v. Commissioner, 9 T.C. 47 (1947), aff'd, 168 F.2d 449 (2d Cir. 1948); Eisenberg v. Commissioner, 5 T.C. 856 (1945), aff'd, 161 F.2d 506 (3d Cir. 1947), cert. denied, 332 U.S. 767 (1947); but see Flitcroft v. Commissioner, 328 F.2d 449 (9th Cir. 1964), rev'g 39 T.C. 52 (1952).

Significantly, in each of the foregoing cases, the court refused to let a retroactive judgment change a federal tax liability for a prior year. In the present case, however, we are concerned with whether a retroactive judgment can be given effect for the very year in which the judgment was rendered. Simply put, the annual accounting principle has no application under these circumstances.

It should be noted that in Brent v. Commissioner, supra, the Fifth Circuit's refusal to recognize the retroactivity of a divorce judgment under Louisiana state law, was expressly limited to the closed year at issue. The Court stated:

> On December 31, 1970, the community between Mrs. Brent and Dr. Brent was still in existence. On that date she owned one-half of the community income, although her ownership was potentially subject to divestiture, and, in accordance with the annual accounting principle, she was taxable on what she then owned.
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> * * *
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> Although the decree is given retroactive effect, under the annual accounting principle effective in federal tax cases, it did not alter the federal tax treatment of income earned in a prior year.

630 F.2d at 261.

If the Fifth Circuit were to decide [redacted]'s [redacted] income tax liability in accordance with the Brent decision, the court would arguably find that since no marital community existed on [redacted], [redacted] was not taxable on one half of the [redacted] community income. The court would also be likely to give the [redacted] judgment of separation retroactive effect for the [redacted] taxable year, since that year had not ended when the judgment was rendered.

In holding that a Louisiana state court judgment of separation should not be given retroactive effect for federal tax purposes, Rev. Rul. 74-393 also relies on the third party creditor exception to retroactivity created by the Louisiana statute itself. As noted, La. Civ. Code Ann. art. 155(b)

provides that judgments of divorce or separation are not to be given retroactive effect so as to prejudice "rights validly acquired in the interim between commencement of the action and recordation of the judgment." The ruling first assumes that the "rights validly acquired" language of article 155(b) would include federal income tax liabilities. The ruling then concludes that "it does not appear that article 155 was intended to empower the Louisiana courts to render judgments affecting Federal income tax liabilities that arise during the interim period."

It has been suggested that the reference to "rights validly acquired" in article 155(b) was not intended to ensure the Government's right to collect income tax liabilities out of community funds. 3/ While this point is debatable, cf. Rev. Rul. 74-393, it is nevertheless clear that the Government acquires no rights to income tax from a particular taxpayer until that taxpayer's tax year has ended. As the Supreme Court stated in Burnet v. Sanford & Brooks Co., supra, 282 U.S. at 363:

> All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt (emphasis added).

Thus, it has been held that income taxes are not "legally due and owing" until the close of the taxable year. In re International Match Corp., 79 F.2d 203 (2d Cir. 1935), cert. denied, 296 U.S. 652 (1935); In re Cooney, 35 Am. Bankr. Rep. 247 (N.D.N.Y. 1938). Since income earned in the first part of the year may be cancelled through later losses, no tax liability can be said to have arisen until the year ends. Fournier v. Rosenbloom, 318 F.2d 525, 527 (1st Cir. 1963), rev'd on other grounds sub nom. Segal v. Rochelle, 382 U.S. 375 (1966); Ludwig Littauer & Co. v. Commissioner, 37 B.T.A. 840, 843 (1938) 4/

3/ Kelly, Is a Louisiana Wife Liable for Federal Income Taxes on Income Earned by her Husband Pending a Judgment of Separation? 23 Loyola L. Rev. 98, 110-12 (1977).

4/ GCM 35082 concludes at pp. 4 and 6 that federal income tax liability arises and vests upon a taxpayer's receipt of income, citing United States v. Lewis, supra. We believe this conclusion needs to be reexamined.

Since [redacted]'s income tax liability for the taxable year [redacted] did not become fixed until the close of [redacted], the Government did not, within the meaning of article 155(b), "validly acquire" any [redacted] income tax "rights" against [redacted] between the beginning of the [redacted] tax year and the judgment of separation rendered in [redacted].5/

But for the annual accounting rule, article 155 would have made the judgment retroactive to [redacted], the date the petition for separation was initially filed. Since the [redacted] tax year has ended before the judgment was rendered, however, the federal annual accounting rule precludes the [redacted] state court judgment from changing the federal tax treatment for the [redacted] tax year. The annual accounting rule does not bar the judgment from being retroactively effective as of the first day of [redacted], the year in which the judgment was rendered.

For the reasons stated above, we intend to seek reconsideration of Rev. Rul. 74-393 in the near future. In the interim, given the Fifth Circuit's rationale in Brent v. Commissioner, supra, we perceive strong litigating hazards in asserting Rev. Rul. 74-393 as a bar to retroactivity of the state court judgment in the year the judgment was granted. Accordingly, we would advise against issuance of the proposed [redacted] income tax deficiency notice.

If we may be of further assistance in this matter, please contact Louis Jack at (FTS) 566-3521.

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5/ We assume that the judgment of separation was duly recorded sometime before the close of the [redacted] tax year. If not, then under article 155(b), the Government's tax rights would not be prejudiced by the retroactive judgment.